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IN THE

Supreme Court of the United States

OCTOBER TERM 1984

ARTHUR L. CHRISTOFFERSON and
THERESA A. CHRISTOFFERSEN,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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QUESTION PRESENTED FOR REVIEW

Whether the District Court erred in holding that the taxpayer, Arthur Christoffersen, as holder of a deferred variable annuity investing in publicly traded mutual fund shares, was not currently taxable on dividends paid on those shares?

PARTIES TO THE PROCEEDING

The caption of the case in this Court lists all parties to the proceeding. Mr. Christoffersen is an employee of Life Investors Insurance Company. Life Investors Insurance Company and Pacific Fidelity Life Insurance Company, which issued the variable annuity contract at issue in this case, are subsidiaries of Life Investors, Inc. Life Investors Insurance Company has provided Mr. Christoffersen with legal assistance in bringing the refund claim in this case.

Subsidiaries of Aegon, N.V. own 72.4% of the common stock of Life Investors, Inc. Other subsidiaries and affiliates of Life Investors, Inc. are:

Investors Security Insurance Company
Life Investors Development Company
USP Real Estate Investment Trust
MidAmerica High Growth Fund, Inc.
MidAmerica Mutual Fund, Inc.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

Petitioners respectfully request that a writ of certiorari be issued to the decision and judgment of the United States Court of Appeals for the Eighth Circuit, entered December 5, 1984, which reversed the decision of the United States District Court for the Northern District of Iowa finding that Petitioners were not required to include currently in income amounts earned by an insurance company on investments made to fund a deferred variable annuity contract purchased by the Petitioners.

OPINIONS BELOW

The opinion of the United States District Court for the Northern District of Iowa, reported at 578 F. Supp. 398 (N.D. Ia. 1984), is reproduced in the Appendix (C-1c). The opinion of the United States Court of Appeals for the Eighth Circuit, reported at 749 F.2d 513 (8th Cir. 1984), is reproduced in the Appendix (A-1a).

JURISDICTION

The judgment of the Court of Appeals was entered on December 5, 1984. An order denying a Petition for Rehearing En Banc was entered on January 3, 1985, and this Petition is filed within 90 days of the entry of that denial (Appendix B-1b). This Court has jurisdiction to review the judgment of the Court of Appeals by writ of certiorari pursuant to 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

This case involves Sections 72(a) and 801(g) of the Internal Revenue Code (26 U.S.C. §§ 72(a), and 801(g)(1)-(3)(1980)).

> "(a) GENERAL RULE FOR ANNUITIES.—Except as otherwise provided in this chapter, gross income includes any amount received as an annuity (whether for a period certain or during one or more lives) under an annuity, endowment, or life insurance contract." 26 U.S.C. § 72(a)
>
> "(g) CONTRACTS WITH RESERVES BASED ON SEGREGATED ASSET ACCOUNTS.—
>
> (1) DEFINITIONS.—
>
> (A) ANNUITY CONTRACTS INCLUDE VARIABLE ANNUITY CONTRACTS.—For purposes of this part, an 'annuity contract' includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract.—
>
> (B) CONTRACTS WITH RESERVES BASED ON A SEGREGATED ASSET ACCOUNT.—For purposes of this part, a 'contract with reserves based on a segregated asset account' is a contract
>
> (i) which provides for the allocation of all or part of the amounts received under the contract to an account, which, pursuant to State law or regulation, is segregated from the general asset accounts of the company,

(ii) which is described in any paragraph of section 805(d) (other than a life, health or accident, property, casualty, or liability insurance contract) or which provides for the payment of annuities; and

(iii) under which the amounts paid in, or the amount paid out, reflect the investment return and the market value of the segregated asset account. If a contract ceases to reflect current investment return and current market value, such contract shall not be considered as meeting the requirements of clause (iii) after such cessation.—

(2) LIFE INSURANCE RESERVES.—For purposes of subsection (b)(1)(A) of this section, the reflection of the investment return and the market value of the segregated asset account shall be considered an assumed rate of interest.—

(3) SEPARATE ACCOUNTING.—For purposes of this part, a life insurance company which issues contracts with reserves based on segregated asset accounts shall separately account for the various income, exclusion, deduction, asset, reserve, and other liability items properly attributable to such segregated asset accounts. For such items as are not accounted for directly, separate accounting shall be made—

(A) in accordance with the method regularly employed by such company, if such method is reasonable, and

(B) in all other cases, in accordance with regulations prescribed by the Secretary." 26 U.S.C. § 801(g)(1)(3)

STATEMENT OF CASE

1. *Deferred Variable Annuities.* Deferred variable annuity contracts provide for the insurance company to make periodic payments ("Annuity Payments") to the policyholder at a date subsequent to the purchase of the annuity with the amount of the Annuity Payments being dependent upon the amounts

earned by the insurance company on investments made with the premium paid by the policyholder. Like all other annuities, deferred variable annuities are insurance products because they shift a mortality risk, the risk of outliving one's income, from the policyholder to the insurance company. Variable annuities were developed in the mid-1950s to provide those policyholders who were willing to assume the investment risk on investments made with their premium dollars with the potential of larger Annuity Payments than is the case with a fixed annuity where the insurance company guarantees the amount of the Annuity Payments but can retain any earnings on investments in excess of those amounts.

Prior to the Eighth Circuit decision in this case, it was universally accepted that the income earned on investments made by the insurance company pursuant to deferred variable annuity contracts was not included in the policyholder's income until Annuity Payments are made. "Since 1918, the income element of an annuity contract is taxable to the policyholder only when and if received." Schorr, Viable Investments in an Inflationary Economy, 39 *N.Y.U. Inst. Fed. Tax.* § 21.03 at 21-12 (1981). *See also, e.g., Investment Annuity, Inc.* v. *Blumenthal,* 442 F. Supp. 681 (D.D.C. 1977), *rev'd on other grounds,* 609 F.2d 1 (D.C. Cir. 1979), *cert. denied,* 446 U.S. 981 (1980); Tucker and Van Mieghem, *Federal Taxation of Insurance Companies* (1983) ¶¶ 1.12, 1.25, 2.19; Caplin, Taxing Tax-Deferred Annuities: A Critique of the 1978 Carter Proposal, 56 *Taxes* 315 (1978); Vinyard, IRS Annuity Rulings Contradict Public Policy on Retirement Savings, 36 *Bus. Law.* 1765, 1768 (1981).

Congress has on several occasions indicated that deferred variable annuities are a valuable retirement device and should be subject to the same principles of taxation as fixed annuities. The Senate Finance Committee has explicitly stated that variable annuities should be taxed in exactly the same manner as fixed annuities:

> "* * * Your committee has added a provision to the House bill to make it clear that variable annuities are in general to be taxed in the same manner as other annuities. . . . Thus, companies issuing such contracts will, if they otherwise qualify, be treated as life insurance companies. *Variable annuities differ from the ordinary or fixed dollar annuities in that the annuity benefits payable under the variable annuity vary with the insurance company's overall investment experience.* The fixed dollar annuity, on the other hand, guarantees the payment of a specified amount irrespective of the actual investment earnings. Both the fixed dollar annuities and the variable annuities, however, are based upon the principle of paying out either specified amounts, or specified units with values which vary with investment experience, over the life of each member of an annuitant group. Thus, in both cases the insuring company bears the mortality risk. In view of this your committee believes variable annuities should in general be treated like other annuities for tax purposes."

S. Rep. No. 291, 86th Cong., 1st Sess. (1959) (1959-2 C.B. 770, 795) (emphasis supplied). Annuities provide a guaranteed source of income during non-productive periods, such as the retirement years, and therefore the tax deferral element of annuities "recognizes the social desirability of deferring tax on individuals in order to encourage retirement savings." Vinyard, IRS Annuity Rulings Contradict Public Policy on Retirement Savings, 36 *Bus. Law.* 1765, 1766 (1981). This principle was recently re-affirmed in the legislative history of the Tax Equity and Fiscal Responsibility Act of 1982 which states that "the use of deferred annuity contracts to meet long-term investment goals, such as income security, is still a worthy ideal." S. Rep. No. 494, 97th Cong., 2d Sess. 350 (1982).

Insurance companies have sold over 800,000 deferred variable annuity contracts with provisions indistinguishable from the provisions relied upon by the Eighth Circuit in its decision. As of the end of 1983, statistics prepared by the American Council of Life Insurance show that over 800,000 individual deferred variable annuity contracts were in force in

the United States. These contracts were funded by approximately $7,000,000,000 in life insurance company reserves. *See* Appendix D-1d.[1]

2. *The Present Case.* On October 15, 1981, Mr. Christoffersen purchased the Pacific Variable Annuity Contract. Like all other deferred variable annuity contracts, the Pacific Variable Annuity Contract provided that:

> 1. The Plaintiff might never need to annuitize the contract.
>
> 2. The Plaintiff may withdraw all or a portion of his account on seven days' notice.
>
> 3. The Plaintiff bears full investment risk.
>
> 4. The insurance company holds assets funding Plaintiff's annuity in a separate subaccount.
>
> 5. Plaintiff is the beneficial owner of the assets in the subaccount.
>
> 6. The Plaintiff had access to the cash value of any dividend paid on the assets in the subaccount on seven days notice.
>
> 7. The Plaintiff receives a tax deferral that is not subject to the restrictions on IRA's.

The Pacific Variable Annuity Contract did differ from some (but not all[2]) deferred variable annuities in that the insurance

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[1] The source material compiled by the American Council of Life Insurance shows a total of 1,029,350 variable annuity contracts in force, but of these 14,090 are making current annuity payments (i.e., are not deferred) and 210,830 are used in connection with IRAs. Hence approximately 800,000 are deferred variable annuities. Reserves for these contracts were estimated using the percentage of contracts that are deferred variable annuities. Such estimate may be conservative since IRAs are limited to $2,000/year.

[2] Many other insurance companies, including Hartford, INA, National Benefit Life and Travelers have also offered deferred variable annuities with this feature.

company invested the premiums in a mutual fund whose shares Mr. Christoffersen could have purchased directly, rather than a mutual fund whose shares can only be purchased for annuity contracts.

Revenue Ruling 81-225 asserted that the tax treatment of a deferred variable annuity depended on whether a contract provided that premiums were invested in shares of a publicly available mutual fund or whether a contract provided that premiums were invested in shares of a mutual fund available only to the insurance company. Rev. Rul. 81-225, *compare* Situations 1 and 5. In an effort to test the validity of Revenue Ruling 81-225, 1981-2 C.B. 12, Mr. Christoffersen paid tax on earnings received by the insurance company from the assets in the subaccount for his Pacific Variable Annuity and then filed a refund claim. However, the government in its briefs before both the trial court and the circuit court largely ignored the public availability issue and argued that Mr. Christoffersen should be taxed currently because of factors that are common to all deferred variable annuities.

The Pacific Variable Annuity Contract purchased by Mr. Christoffersen had all of the characteristics of a typical variable annuity contract. At the trial held before Judge Edward McManus on November 21, 1983, two expert witnesses testified that the Pacific Variable Annuity Contract was a typical annuity contract in accordance with the customary practice of life insurance companies. Furthermore, the uncontroverted evidence presented at trial established that all deferred variable annuities permit a surrender of all or part of the contract prior to the commencement of annuity payments and place the economic risk of investments made under the contract on the policyholder. As a deferred variable annuity, the Pacific Variable Annuity Contract was established and regulated under California insurance law and was licensed for sale as an insurance product in all forty-seven states in which it was sold.

On February 3, 1984, Judge McManus ruled in favor of Mr. Christoffersen, concluding that "the contract is an annuity pursuant to 26 U.S.C. 801(g) qualifying for deferred taxation." 578 F. Supp. at 399. *See* Appendix C-2c. On December 5, 1984, a three-judge panel of the Eighth Circuit Court of Appeals reversed the District Court's decision. 749 F.2d 513 (8th Cir. 1984). *See* Appendix A-1a. In reaching its decision, the Eighth Circuit ignored the distinction that the Pacific Variable Annuity Contract could invest in shares of publicly available mutual funds and instead relied on those factors that are common to all deferred variable annuities. As a result, the decision affects all 800,000 deferred variable annuity contracts now in force or which may be subsequently written. On January 3, 1985, a Petition for Rehearing En Banc was denied. *See* Appendix B-1b.

REASONS FOR GRANTING WRIT

Certiorari Should Be Granted to Review Reversal by the Circuit Court of the Congressional Intent to Permit Variable Annuities and of More than 25 Years of Accepted Taxation of Annuities.

Review of this case is necessary to prevent the decision below from seriously disrupting the pattern of taxation of deferred variable annuities that has been in place since the 1950s. Since that time, deferred variable annuities have grown into a major segment of the insurance industry with, as of 1983, over 800,000 policyholders of deferred variable annuities for which insurance companies maintained reserves of approximately $7,000,000,000. *See* Appendix D-1d. During this period Congress has consistently noted the importance of deferred variable annuities and has enacted those provisions necessary to assure that deferred variable annuities were treated as all other variable annuities. *See, e.g.,* IRC § 801(g) (permitting insurance companies to include the segregated account in their insurance reserves).

The factors set forth in the opinion for concluding that Mr. Christoffersen should be currently taxed do not distinguish the Pacific Variable Annuity Contract from any of the 800,000 other deferred variable annuities presently in force. The factors[3] listed in the panel decision are:

1. The Plaintiff might never need to annuitize the contract.

2. The contract provides for withdrawal on seven days notice.

3. The Plaintiff bears full investment risk.

4. The insurance company holds assets funding Plaintiff's annuity in a separate subaccount.

5. The Plaintiff is the beneficial owner of the assets in the subaccount.

6. The Plaintiff had access to the cash value of any dividend paid on the assets in the subaccount on seven days' notice.

7. The contract provides a tax deferral that is not subject to the restrictions on IRA's.

As noted in the Statement of the Case, all of these factors are standard for any deferred variable annuity. The very purpose of any variable annuity is that the policyholder bears the investment risk and is the beneficial owner of assets in which his premiums are invested. The use of separate accounts for such investments is a mechanical device to ensure that a policyholder's return is not affected by other insurance company investments. The provision for withdrawal on seven days notice (with the consequence that Annuity Payments may never

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[3] The decision also makes reference to the ability to change between subaccounts. This factor is common to some, but not all, annuity contracts. The I.R.S. in Revenue Ruling 82-54, 1982-1 C.B. 11, explicitly concluded that the ability to make such changes does not affect the tax consequences. See also Section 1035 of the Internal Revenue Code ("Code").

commence) is required by the federal securities laws. 15 U.S.C § 80a22. In addition, the Conference Report on the Deficit Reduction Act of 1984, H. Rep. 98-861, 98th Cong., 2d Sess. 1053 (1984) ("Conference Report"), states that a variable annuity provides that (1) premiums are invested in a separate account, (2) the policyholder bears investment risk, (3) the contract can be surrendered and (4) the starting date may be deferred without the policyholder being taxed prior to distribution of the income earned.

> In general, . . . a variable annuity[1] . . . is a contract under which any amounts or premiums received are invested in a separate asset account of the insurance company, and the amounts paid in or paid out reflect the investment return and the market value of such separate account. Under a variable annuity, either the cash surrender value before the annuity starting date or annuity payments made after the annuity starting date (or both) reflects the investment activity of the separate account . . . .
>
> Generally, income on an annuity contract is taxed only once, at at the policyholder level when the income is distributed.
>
> [1] The term variable annuity is used generally to refer to a contract which reflects the investment activity of a company and also a contract that reflects the investment return and market value of a segregated asset account within a company, although the latter may be referred to more specifically as "a contract with reserves based on a segregated asset account." See present-law sec. 801(g).

Conference Report at 1053 (footnote in original). This report reaffirms that the characteristics of the Pacific Variable Annuity Contract were typical of all deferred variable annuities and that the decision of the District Court was correct.

The evidence is uncontroverted that the only feature of the Pacific Variable Annuity Contract (including obtaining tax

benefits, such as a tax deferral similar to an IRA, but without all of its restrictions)[4] distinguishing it from some other deferred variable annuities is that the insurance company would invest premiums in shares of a mutual fund that Mr. Christoffersen could have purchased apart from the annuity contract rather than a mutual fund set up solely for variable annuity investments. This one difference is not discussed in the decision of the Eighth Circuit and is barely mentioned in the government's brief. Since the decision does not rest on this distinction,[5] the decision below must be regarded as affecting all deferred variable annuities with the result that the Eighth

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[4] The enactment of provisions relating to IRAs does not indicate a Congressional intent to restrict annuities. An IRA simply provides different tax benefits and is subject to different restrictions than an annuity. While both annuities and IRAs provide a tax deferral, only IRAs provide a current deduction for amounts contributed. Annuities are subject to provisions similar to those for IRAs to ensure that annuities are properly used to provide long-term retirement income. Section 72(q) imposes a 5% penalty on premature distributions and section 72(e) provides that withdrawals will first be treated as withdrawals of income and not as a return of capital.

However, annuities must be purchased with after-tax dollars while IRAs are purchased with pre-tax dollars. Congress chose to impose additional limitations (i.e., the $2,000 limitation) on when these benefits of an IRA (i.e., a deduction from income) would be available. But nothing indicates that Congress intended that annuities, which do not provide all the benefits of IRAs, should be subject to all of the same restrictions.

[5] While not addressed by the Eighth Circuit, the record actually establishes that the two situations should be treated identically. In either case, the earnings on the premiums subject to the tax deferral could be equal. In either case, the "control" exercised by the policyholder is limited to choosing whether or not to buy an annuity with those investment objectives. The advantages derived from "wrapping" the annuity around the publicly available fund are that the policyholder has more information about the investments upon whose performance his annuity payment will depend and more insurance companies, particularly smaller ones, can offer variable annuities since they need not maintain in-house investment expertise.

Circuit has written a decision that reverses more than 25 years of settled law and will affect over 800,000 policyholders.

By taxing Mr. Christoffersen currently on earnings from the investments made by the insurance company with his premiums, the Eighth Circuit decision reverses 25 years of practice, thwarts the intent of Congress and actually contradicts published IRS rulings in this area.

The taxation of deferred variable annuities has been well established. *See, e.g.,* Tucker and Van Mieghem, *Federal Taxation of Insurance Companies* (1983) ¶¶ 1.12, 1.25, 2.19; Caplin, Taxing Tax-Deferred Annuities: A Critique of the 1978 Carter Proposal, 56 *Taxes* 315 (1978); Vinyard, IRS Annuity Rulings Contradict Public Policy on Retirement Savings, 36 *Bus. Law.* 1765, 1768 (1981); Schorr, Viable Investments in an Inflationary Economy, 39 *N.Y.U. Inst. Fed. Tax.* § 21.03 (1981). While it may have been possible for a court 25 years ago to have concluded that the basic characteristics of a deferred variable annuity (such as beneficial ownership of the assets) should result in current taxation to the policyholder, at this time such a change should depend on legislation. Furthermore, Congress during these 25 years has repeatedly acknowledged the tax deferral characteristic of deferred variable annuities and has even enacted legislation to ensure these tax objectives were met. S. Rep. No. 291, 86th Cong., 1st Sess. (1959) (1959-2 C.B. 770, 795); S. Rep. No. 494, 97th Cong., 2d Sess. 350 (1982); H. Rep. 98-861, 98th Cong., 2d Sess. 1053 (1984). Finally, the published rulings of the IRS requiring current taxation of certain variable annuities, because of their investment characteristics, have approved the other features of deferred variable annuities that are relied upon by the Eighth Circuit as a basis for current taxation. (See Appendix E-1e.)

The government may argue that the decision should be limited to one involving solely the fact that the premiums were invested in shares of a publicly available mutual fund and as such is mooted by Section 817 of the Code, added by the Tax

Reform Act of 1984, which permits the Treasury to issue regulations regarding the diversification of investments made by an insurance company for a variable annuity. The opinion, the government briefs and the facts relied upon simply do not support the conclusion that the opinion can be so limited. Even a deferred variable annuity that complied with the Treasury's diversification provisions, whenever they are issued, would still have the other characteristics of a deferred variable annuity with which the Eighth Circuit found fault, including the investment risk being borne by the policyholder and the ability of the policyholder to withdraw the accumulated value before Annuity Payments begin. Thus, there is no way that a court could distinguish such an annuity contract from the Pacific Fidelity Variable Annuity Contract, which the Eighth Circuit concluded resulted in current taxation to the policyholder. The government may also claim that it would not attempt to enforce the decision in its literal sense, but the government in its briefs below argued precisely for a decision that would affect all deferred variable annuities.

Even if the government limited its use of the case to those situations involving publicly available mutual funds, the Eighth Circuit decision still raises the possibility of the courts being jammed with suits resulting from that opinion. Presumably, all of the 800,000 policyholders of deferred variable annuities have not been reporting any current income from their deferred variable annuities based on the status of the law prior to the Eighth Circuit decision. In many cases the statute of limitations for those years will have lapsed. Comparing their policies to the facts disclosed in *Christoffersen* v. *United States,* 749 F.2d 513, they would be justified in concluding that such income should have been included previously with the result that the return of income previously earned through subsequent Annuity Payments should be tax free. Given the absence of any other Circuit Court decision on this issue, they should at least have substantial authority for this position. We have been unable to determine how much of the $7,000,000,000 of

insurance reserves might permanently escape tax on this basis, but it could be billions of dollars.

Nothing in the mitigation provisions would prevent such a conclusion. In general, under the mitigation provisions of the Code, the statute of limitations may be extended one year from the date of a "determination" which adopts a position that is inconsistent with the prior position of a taxpayer in a closed year. In order for the mitigation provisions to apply, however, one of the "circumstances of adjustment" contained in Section 1312 must exist. No such circumstance would exist in this situation.[6]

The nature of annuity contracts makes it important that a writ of certiorari be granted now rather than after a split has developed among the circuits. For any one policyholder, the amount of taxes due are normally too small and the cost of litigation too high to bring a suit. The insurance company cannot itself contest the liability directly since it does not bear

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[6] Sections 1312(1), 1312(2), 1312(3)(A), 1312(5) and 1312(6) clearly would not apply in the instant case. Section 1312(7) permits application of the mitigation provisions if a subsequent determination sets the basis of property, and in respect of any *transaction* upon which such basis depends, there occurred an erroneous omission from gross income. However, the courts have made clear that for section 1312(7) to apply there must be the passage of title and the disposition or acquisition of property. *See e.g., Gardiner* v. *United States,* 536 F.2d 903 (10th Cir. 1976) (failure to take depreciation deductions is not a "transaction upon which basis depends" within the meaning of Section 1312(7)). If the I.R.S. assessed a deficiency in the year Annuity Payments commenced because a taxpayer treated amounts earned on assets in the subaccount as taxable in a prior year but the I.R.S. failed to prevail on that theory, section 1312(3)(B) provides a limited exception that would permit a deficiency to be assessed for amounts earned in years that were open when the deficiency in the later years was first maintained by the I.R.S. However, Section 1312(3)(B) would not permit the I.R.S. to assess a deficiency in years that were already closed at the time of the Eighth Circuit decision.

the tax. The difficulties of bringing suits in this area are graphically illustrated by the fact that only one other case regarding the taxation of deferred variable annuities during the accrual phase exists, *Investment Annuity, Inc.* v. *Blumenthal,* 442 F. Supp. 681 (D.D.C. 1977), *rev'd on other grounds,* 609 F.2d 1 (D.C. Cir. 1978), *cert. denied,* 446 U.S. 981 (1980). In that case the district judge also concluded that the policyholder was not currently taxable on amounts earned on the assets in the subaccount, but the Circuit Court dismissed the suit under the Tax Injunction Act without reaching the merits, since the suit was brought by the insurance company.

In addition, the mere issuance of an adverse Revenue Ruling renders an insurance company's deferred variable annuity unmarketable. Regardless of their view of the validity of the ruling, they typically will develop another product or will leave the industry entirely since the insurance company cannot maintain its marketing support in place without a product for several years while awaiting a definitive court decision.

Hence, while a decision in this case affects a large number of policyholders and insurance companies, the possibility of these policyholders and insurance companies obtaining relief from the erroneous decision of the Court of Appeals is remote, unless a writ of certiorari is issued in this case.

CONCLUSION

For all of the foregoing reasons, Petitioner respectfully requests that a Writ of Certiorari issue to review the judgment of the Court of Appeals for the Eighth Circuit.

Respectfully submitted,

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APPENDICES

APPENDIX A

Opinion of the United States Court of Appeals
for the Eighth Circuit

(December 5, 1984) **(749 F.2d 513)**

(Argued October 10, 1984 Decided December 5, 1984)

Docket No. 84-1420-NI

ARTHUR L. CHRISTOFFERSEN and
THERESA A. CHRISTOFFERSEN,

Appellees,

v.

UNITED STATES OF AMERICA,

Appellant.

BEFORE:

Lay, Chief Judge, and Ross and McMillian, Circuit Judges.

LAY, Chief Judge. The issue presented on this appeal is whether the Pacific Variable Annuity Contract, purchased by the taxpayers Arthur L. and Theresa A. Christoffersen in 1981, is an annuity consistent with 26 U.S.C. § 801(g) (1976) and qualifies for deferred tax treatment under 26 U.S.C. § 72 (1976).[1] The district court, The Honorable Edward J. McManus presiding, entered judgment in favor of the taxpayer, and the government has appealed. We vacate the judgment of the district court and remand with directions to enter judgment in favor of the government.

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[1] 26 U.S.C. § 72 was amended by the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324. However, because this case involves tax year 1981, we deal with the statute effective in 1981.

The Christoffersens purchased the Pacific Variable Annuity Contract from Pacific Fidelity Life Insurance Company for $50,000. The Contract gave the Christoffersens the right, in the year 2021, to purchase an annuity based on 1981 mortality tables.[2] The bulk of the $50,000 was invested, at plaintiffs' direction, in the Fidelity Daily Income Trust, a mutual fund which invested in high-grade, short-term money market instruments.[3] The Trust generated $1,532 of income in 1981 which taxpayer directed to be reinvested in the Trust. The Christoffersens reported it on their joint 1981 tax return. Plaintiffs immediately filed an amended return and claimed a refund of the $647 tax resulting from the inclusion of that income. The refund claim was denied by the IRS and the Christoffersens filed this complaint in the United States District Court for the Northern District of Iowa.

The district court relied upon *Investment Annuity, Inc.* v. *Blumenthal* [77-2 USTC ¶ 9723], 442 F. Supp. 681 (D. D. C. 1977), *rev'd on procedural grounds,* [79-2 USTC ¶ 9615], 609 F.2d 1 (D. C. Cir. 1979), *cert. denied,* 446 U.S. 981 (1980), to conclude, as a matter of law, that plaintiffs' contract was a variable annuity and qualified for deferred tax treatment under section 72(e). For reasons discussed, we cannot endorse the approach of the district court in the *Investment Annuity* case.[4]

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[2] Historically, the mortality tables have risen as medical science increases life expectancy. It is likely that the tables in 2021 will be less beneficial to the annuitant than the 1981 tables. There is, however, the possibility that life expectancy might decrease. With an option-type contract such as we have here, the investor is able to obtain the most favorable rates of return by selecting either the 1981 tables or the current tables in 2021. The profit for the insurance company lies in the premium paid for the contract and the possibility that the investor will not live long enough to exercise it.

[3] Pacific Fidelity retained $3.79 for administrative expenses and $84.02 as the annuity option premium.

[4] The United States District Court for the District of Columbia based its holding on a factual finding that the insurance company, and not the policyholder, was the owner of the assets in the annuity sub-account. *Investment Annuity,* 442 F. Supp. at 688-91.

The Pacific Variable Annuity Contract is an investment program which includes a contract for the purchase of an annuity. However, investors need never exercise the annuity feature of the contract. This form of contract is called a "wrap around annuity."[5] The purchaser of the Contract selects which of the mutual funds offered by Pacific Fidelity to invest in and can change to another fund at any time. The investor bears the full investment risk and may withdraw any or all of his investment upon seven days notice. Pacific Fidelity holds the investor's mutual fund shares in a sub-account of its Separate Account. The taxpayer, in purchasing the Contract, did not become obligated to purchase an annuity. The only difference between Pacific Fidelity's arrangement and that of a traditional brokerage firm is the fact that the investor is limited to withdrawing cash. While a broker would re-register shares from its street name into the investor's name upon demand, Pacific Fidelity will sell off the shares it holds for the investor and transfer the cash value.

The district court's reliance on 801(g) is misplaced.[6] The court reasoned that the taxpayer's Contract with Pacific Fidelity was an annuity pursuant to section 801(g) qualifying for

---

[5] The name comes from the fact other investment assets such as stocks, bonds or mutual funds are wrapped in an annuity in the hope that earnings from such investments will not be taxable to the taxpayer in the same manner as if the taxpayer purchased the assets directly. See Appleman, Insurance Law and Practice § 81 n. 5 (1981).

[6] 26 U.S.C. § 801 (1976):

> (g) Contracts with reserves based on segregated asset accounts
>
> (1) Definitions
>
> (A) Annuity Contracts include variable annuity contracts
>
> For purposes of this part, an "annuity contract" includes a contract which provides for the payment of a variable annuity computed on the basis of recognized mortality tables and the investment experience of the company issuing the contract.

deferred treatments under section 72.[7] Section 801(g), which does not apply to individual taxpayers, defines variable annuities and allows them to be treated as other annuities for life insurance company taxation purposes. Unless Pacific Fidelity is found to be the beneficial owner of the assets held in the subaccount, section 801(g) is not relevant to this case. Section 72, on the other hand, relates to income received under an annuity. The Christoffersens do not argue that the monies received by the Trust are funds received under an annuity. The annuity does not start until the year 2021 and then only if the taxpayer elects to exercise his contract at that time.

Although Pacific Fidelity maintains the shares in its name, the Christoffersens are the beneficial owners of the investment funds held in their Pacific Fidelity account. As stated by the Supreme Court in *Griffiths* v. *Commissioner* [40-1 USTC ¶ 9123], 308 U.S. 355, 357-58 (1939):

> We cannot too often reiterate that "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid." *Corliss* v. *Bowers* [2 USTC ¶ 525], 281 U.S. 376, 378. And it makes no difference that such "command" may be exercised through specific retention of legal title or the creation of a new equitable but controlled interest, or the maintenance of effective benefit through the interposition of a subservient agency.

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[7] 26 U.S.C. § 72 (1976):

> (e) Amounts not received as annuities.
>
> (1) General Rule
>
> If any amount is received under an annuity, *** if such amount is not received as an annuity, *** then such amount—
>
> ***
>
> (B) *** shall be included in gross income, but only to the extent that it (when added to amounts previously received under the contract which were excludable from gross income under this subtitle or prior income tax laws) exceeds the aggregate premiums or other consideration paid.

The Christoffersens have surrendered few of the rights of ownership or control over the assets of the sub-account. Compare *Helvering* v. *Clifford* [40-1 USTC ¶ 9265], 309 U.S. 331 (1940). The payment of annuity premiums, management fees and the limitation of withdrawals to cash, rather than shares, do not reflect a lack of ownership or control. Similar requirements may be placed on traditional brokerage or management accounts. Similarly, the possibility that the assets will be converted into an annuity in 2021 does not significantly impair the Christoffersens' ownership since all, or any portion, of the assets may be withdrawn before that time. Upon examination of the Contract as a whole, we must conclude that the Christoffersens, and not Pacific Fidelity, own the assets of the sub-account.

Moreover, despite the fact that the dividends were held in the sub-account and not distributed to the Christoffersens, we hold that the dividends are income received. The Christoffersens have access to all of the assets in the account at any time. The fact that the Christoffersens chose to reinvest, rather than withdraw, the income from the assets of the account should not affect their tax liability. Under the long recognized doctrine of constructive receipt,[8] the income generated by the account assets should be taxed to the plaintiffs in the year earned, not at some later time when the Christoffersens choose to receive it. This is the essence of Rev. Rul. 81-225, which we find persuasive.

---

[8] Treas. Reg. § 1.451-2(a):

> (a) *General Rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.***

26 C. F. R. § 1.451-2(a) (1984).

Because the dividends were not received under any annuity, section 72(e) is not applicable to taxpayers. The dividends must be included in gross income. We agree with the government's argument that the taxpayers' so-called variable annuity provides them with a tax deferral basis similar to an IRA without the substantial restrictions imposed by Congress on IRAs. See section 408(f)(1). Therefore, the judgment of the district court is reversed and remanded with directions to enter judgment in favor of the United States. Judgment reversed.

APPENDIX B

Order of the United States Court of Appeals for the Eighth Circuit Denying Appellees' Motion for Rehearing

September Term, 1984.

(January 3, 1985)

Docket No. 84-1420-NI

ARTHUR L. CHRISTOFFERSEN and
THERESA A. CHRISTOFFERSEN,

Appellees,

v.

UNITED STATES OF AMERICA,

Appellant.

Appellees' petition for rehearing en banc has been considered by the Court and is denied.

Petition for rehearing by the panel is also denied.

January 3, 1985

APPENDIX C

Opinion of the United States District Court
for the Northern District of Iowa
(February 3, 1984) (578 F. Supp. 398)
Docket No. C 82-206

ARTHUR L. CHRISTOFFERSEN and
THERESA A. CHRISTOFFERSEN,

Appellees,

v.

UNITED STATES OF AMERICA,

Appellant.

BEFORE:

McManus, Chief Judge

This action for the recovery of federal income taxes paid for the year ending December 31, 1981 was tried to the court on November 21, 1983. All proposed findings of fact and conclusions of law have been received, considered along with the entire record and the court now makes the following:

FINDINGS OF FACT

1. Plaintiffs, husband and wife, are calendar year taxpayers on a cash basis who have resided in Cedar Rapids, Linn County, Iowa, at all times material.

2. Defendant is the United States of America, Internal Revenue Sevice.

APPENDIX D

VARIABLE ANNUITY PLANS IN THE UNITED STATES 1983
(Dollar Amounts in Thousands)

	Group Plans		
	Equity Fund Index	Other Indices	Total Group
IN FORCE YEAR-END 1983			
No. of Plans	38,150	620	38,770
No. of Persons	1,520,060	79,640	1,599,700
Reserves			
Variable	$ 4,721,900	$ 635,620	$ 5,537,520
Other	7,326,300	491,220	7,817,520
Total	$12,048,200	$1,126,840	$13,175,040
CONSIDERATIONS IN 1983			
Variable	$ 514,370	$ 41,180	$ 555,550
Other	782,250	67,910	850,160
Total	$ 1,296,620	$ 109,090	$1,405,710
VARIABLE ANNUITIES IN COURSE OF PAYMENT			
No. of Persons Receiving Payments Year-End 1983	24,880	12,420	37,300
Annualized Income			
Variable	$ 32,940	$ 40,690	$ 73,630
Fixed	165,600	40,110	205,710
Total	$ 198,540	$ 80,800	$ 279,340

Note: The table includes variable and fixed data on plans which provide variable ann part. Numbers of plans and active lives under plans which provide an option f retirement are not included. For 1983 there were 880 such groups covering 126,09 plans.

Source: American Council of Life Insurance

This article is taken from page 36 of the *1984 Life Insurance Fact Book*, published Insurance.

BEST AVA

Individual Plans	Total (Group and Individual)
—	—
1,029,350	2,629,050
$6,056,780	$11,414,300
2,843,590	10,661,110
$8,900,370	$22,075,410
$1,171,250	$ 1,726,800
430,550	1,280,710
$1,601,800	$ 3,007,510

1983

14,090	51,390
$ 7,550	$ 81,180
19,870	225,580
$ 27,420	$ 306,760

ity benefits either in whole or in
a variable annuity payout at
persons, and 33,610 individual

y the American Council of Life

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APPENDIX E

COMPARISON BETWEEN IRS APPROVED VARIABLE ANNUITY AND PACIFIC FIDELITY VARIABLE ANNUITY

Feature	IRS Approved Variable Annuity	Pacific Fidelity Variable Annuity
Investment risk on annuitant	Yes[1, 2, 3]	Yes
Part or all of value of an annuity account can be withdrawn on 7 days notice	Yes[1]	Yes
Annuitant can select which of mutual funds offered by insurance company to have his account invested in	Yes[1]	Yes
Annuitant can change from one offered fund to another offered fund	Yes[1, 2]	Yes
Annuity payments begin at a future date of policyholder's choice	Yes[1]	Yes
Insurance company charges a small percent of the daily net asset value as a fee for reimbursement for mortality risks and additional expenses	Yes[1]	Yes
Annuitant is not obligated to annuitize the contract	Yes[1]	Yes
Annuity premiums not subject to IRA limitations	Yes[1, 2, 3]	Yes
The investment vehicle is a publicly available mutual fund	No[1]	Yes
The investment vehicle is not a publicly available mutual fund	Yes[3]	No

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[1] See Rev. Rul. 81-225, Situation 5, 1981-2 C.B. 12.

[2] See Rev. Rul. 82-54, 1982-1 C.B. 11.

[3] See Rev. Rul. 82-55, 1982-2 C.B. 12.

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CLERK

No. 84-1566

In the Supreme Court of the United States

OCTOBER TERM, 1984

ARTHUR L. CHRISTOFFERSEN, ET UX., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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8 pp

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MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioner challenges the court of appeals' holding that he was the true owner, for federal tax purposes, of certain publicly-traded mutual fund shares underlying a "wrap-around annuity" that he had purchased, and hence that he was currently taxable on the income generated by those shares. The decision below is correct. As petitioner concedes, there is no conflict among the circuits on the question presented. There is no basis for further review.

1. In October 1981, petitioner Arthur Christoffersen[1] purchased a so-called "variable annuity contract" from Pacific Fidelity Life Insurance Company (Pacific) for $50,000 (Pet. App. 2a). The type of contract petitioner

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[1]Petitioner Theresa Christoffersen is Arthur's wife and is a party solely by virtue of having filed a joint federal income tax return with him for the tax year in question.

acquired is commonly known as a "wrap-around annuity."[2] The contract gave petitioner the option, in the year 2021, to purchase an annuity based on 1981 mortality tables; petitioner was charged an annuity option premium of $84.02 for this privilege (Pet. App. 2a & n.3).[3] He was also charged $3.79 for administrative expenses (*ibid.*). The balance of his $50,000 investment, or $49,912.19, was to be invested in any one of six publicly-traded mutual funds offered by Fidelity Management & Research Company. Petitioner was free to choose whichever fund he wanted. He directed that his $49,912.19 be invested in Fidelity Daily Income Trust, a money-market fund (*id.* at 2a).

The money-market mutual fund shares purchased at petitioner's direction were held in a separate sub-account maintained by Pacific; the shares were not chargeable with Pacific's other liabilities (Pet. App. 3a). As earnings accrued on the shares, petitioner could elect to have the income paid to him currently, or to have it reinvested in additional shares; he chose the latter option (*id.* at 2a). Petitioner bore the investment risk with respect to the shares and had the right (subject to a $10 surrender fee) to withdraw his investment, in whole or in part, on seven days' notice (*id.* at 3a). If petitioner lived until November 1, 2021, he would have the

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[2]The arrangement is so named because investment assets like stocks, bonds, or mutual fund shares are "wrapped" in an annuity contract in the hope that the investor may thereby escape current taxation on the investment income, a result that would of course be impossible if the investor were to purchase such assets directly. See Petrie, *Eroding the Tax Benefits of Wrap-Around Annuities: An Analysis of Revenue Ruling 81-225*, 34 U. Fla. L. Rev. 95 (1981).

[3]The annuity option premium (sometimes called the "mortality risk premium") was supposedly designed to compensate the insurance company for the risk that the taxpayer's life expectancy on November 1, 2021 -- should he survive until then -- would be longer than predicted by the 1981 mortality tables used to calculate the contract annuity rates. This premium was computed annually at a rate of 0.8% on the accumulated value of the taxpayer's "sub-account" (R. Doc. 24).

option at that time to use the accumulated value of his investment to purchase an annuity (*ibid.*). Otherwise, the accumulated value would be paid to him in cash (*ibid.*).

During the last three months of 1981, petitioner's "sub-account" earned income of $1,532 (Pet. App. 2a). Petitioner and his wife initially reported this $1,532 as interest income on their 1981 federal income tax return. Subsequently, however, they filed a claim for refund, contending that the $1,532 was not taxable.

Upon the Commissioner's denial of their claim, petitioners brought this refund suit in the United States District Court for the Northern District of Iowa. That court held that petitioner's contract with Pacific was "an annuity pursuant to 26 USC 801(g) qualifying for deferred taxation under 26 USC 72." It thus ruled that the $1,532 was not currently taxable to petitioner (Pet. App. 2c).

The court of appeals unanimously reversed (Pet. App. 1a-6a). It held that petitioner was the true owner for tax purposes of the money-market fund shares, since he had ready access to those assets at all times and had virtually complete control over their disposition (*id.* at 5a). And it held that petitioner was required to include the $1,532 in income for 1981, since he had the unrestricted right to receive that money and was thus in "constructive receipt" of the income for tax purposes (*ibid.*).

2. The decision below is correct. Petitioner challenges it on the theory that his investment is indistinguishable from any other "variable annuity contract," and hence that he should qualify for the tax deferral benefits generally accorded purchasers of that insurance product. But while petitioner's brief, like the contract he purchased, is redolent

of the language of insurance, he says little about the operative provisions of the Internal Revenue Code.[4] The pertinent definitional provision, Section 801(g)(1)(A), says that a life insurance annuity contract includes "a contract which provides for the payment of a variable annuity computed on the basis of * * * the investment experience *of the company issuing the contract*" (emphasis added). And Section 801(g)(5) speaks of "life insurance reserves" based on the underlying investment assets. The relevant Code provisions, in short, presuppose that a contract is a "variable annuity contract" for federal tax purposes only if the underlying assets are owned by the insurance company and not by the policyholder.

The court of appeals correctly held that the money-market mutual fund shares at issue here were "owned," for federal tax purposes, by petitioner and not by Pacific. It has long been established that taxation of income follows ownership and that, where title and beneficial ownership are split between two parties, beneficial ownership controls. *Griffiths* v. *Commissioner*, 308 U.S. 355, 357-358 (1939); *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930). Where (as here) some but not all of the rights associated with property have been transferred from one person to another, the determination of who "owns" the property for tax purposes requires a comparision of the rights retained with those surrendered. Where the former are more substantial than the latter, no shift in ownership is recognized. The Court made this clear in *Helvering* v. *Clifford*, 309 U.S. 331 (1940), where it held that the grantor of a trust had retained such substantial incidents of ownership with respect to the corpus that he remained its owner for federal tax purposes, notwithstanding that the trust was perfectly valid in other respects.

---

[4]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

The court of appeals correctly held that petitioner had retained virtually all, and surrendered virtually none, of the incidents of ownership of the money-market mutual fund shares involved here. He decided what his money would be invested in; he bore the full investment risk; he had the right to receive the investment income currently; and he could redeem his investment in whole or in part whenever he wished. Indeed, petitioner had vis-a-vis the shares essentially the same rights as those possessed by any investor in a publicly-traded money-market mutual fund. To be sure, petitioner also had the right — which cost him $84.02 — to purchase an annuity in the year 2021, should he be alive then and choose to exercise his option. But the availability of that separable and discrete option obviously does not mean that the money-market fund shares were "owned" by the insurance company, or that the overall arrangement was a "variable annuity contract" for purposes of Section 801(g).

Since petitioner owned the shares, he was taxable in 1981 on any income the shares generated in 1981. It has long been established that an item of income is includable in the gross income of a cash-basis taxpayer for the year in which it is received, actually or constructively. *Corliss* v. *Bowers, supra*; Treas. Reg. § 1.451-2(a). Income is deemed "constructively received" when it is made available to the taxpayer on his demand without substantial restrictions. *Ibid.*

The court of appeals correctly held that petitioner constructively received the $1,532 in money-market fund income during 1981 because he had the unrestricted right to have that sum paid to him in cash. To be sure, petitioner elected not to take the cash, and chose instead to have it reinvested in additional shares. But a taxpayer cannot escape tax merely by turning his back on income while retaining and reinvesting it.

3. The decision below is the first appellate decision to address the federal tax consequences of "wrap-around annuities." Thus, as petitioner concedes (Pet. 14-15), there is no conflict among the circuits on the question presented.

Nor, contrary to petitioner's suggestion (Pet. 12), does the case warrant certiorari absent a conflict on the theory that the decision below "reverses 25 years of practice" in the taxation of insurance companies. The decision below does not address the tax consequences of "variable annuity contracts" under Code Sections 72 and 801(g). It holds simply that the money-market mutual fund shares involved here were owned by petitioner, not by the insurance company, and hence that petitioner, not the insurance company, is taxable on the income those shares generated. This principle is not novel.[5]

The result below, finally, works no unfairness upon petitioner. He purchased, through the medium of an insurance company, shares in a money-market mutual fund. Although his shares were held (as it were) in "street name," his rights with respect to those shares were functionally equivalent to those possessed by any money-market fund investor. Petitioner also purchased, for a modest sum, an option to buy an annuity 40 years down the road. That sum effectively represented a gamble that he, unlike other money-market fund investors, might thus defer tax on up to 40 years' worth

---

[5]The IRS formally announced eight years ago that it would require the purchaser of a "wrap-around" annuity to include currently in income the earnings from the "wrapped" assets where, under the terms of the contract, the purchaser rather than the insurance company possessed the more substantial incidents of ownership. Rev. Rul. 77-85, 1977-1 C.B. 12. In Rev. Rul. 81-225, 1981-2 C.B. 12, the Commissioner reaffirmed that ruling, holding that an insurance company will be considered to own "wrapped" mutual fund shares only where the investments are controlled by the insurance company and the shares are not offered for sale directly to the general public.

of investment income. He did not wager a large amount. He got more or less what he paid for.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

MAY 1985

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